No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

MIDLAND FORD TRACTOR COMPANY

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered in the above-entitled case April 29, 1960.

CITATION TO OPINIONS BELOW

The opinion of the Court of Appeals is reported at 277 F. 2d 111 and appears in the Appendix hereto, p. 1.

The findings of fact and opinion of the Tax Court is unofficially reported at ¶58, 213 P-H Memo T.C. and appears in the record at pages 316-328. It appears in the Appendix hereto, p. 9.

JURISDICTION

The judgment of the Court of Appeals was entered April 29, 1960. Petition for Rehearing was denied by the Court of Appeals June 13, 1960. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTIONS PRESENTED

I.

Was the Eighth Circuit correct in holding that "the Tax Court was not bound to believe the testimony of any witnesses, even though not directly contradicted"?

II.

Does the Court of Appeals have the duty to review the evidence presented to the Tax Court in a case where the question is whether salaries paid by a corporation are reasonable? The Eighth Circuit held that the Tax Court is "the exclusive judge of the credibility of the witnesses and the weight to be given their testimony."

Several Circuit Courts of Appeals have reached a conclusion contrary to the conclusion of the Eighth Circuit in the case at bar and held that they have the duty and authority to review the evidence and reverse the Tax Court where the evidence before the Tax Court should have been convincing, but did not convince the Tax Court.

STATUTES INVOLVED

Sec. 7453, Internal Revenue Code of 1954.

> "The proceedings of the Tax Court and its divisions shall be conducted in accordance with such rules of practice and procedure (other than rules

of evidence) as the Tax Court may prescribe and in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia."

Sec. 7482(a), Internal Revenue Code of 1954.

"The United States Courts of Appeals shall have exclusive jurisdiction to review the decisions of the Tax Court, except as provided in section 1254 of title 28 of the United States Code, in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury; and the judgment of any such court shall be final, except that it shall be subject to review by the Supreme Court of the United States upon certiorari, in the manner provided in section 1254 of title 28 of the United States Code."

STATEMENT

Two questions were decided by the Court below. Certiorari is sought only with respect to the decision on the salary issue, which involves the duty and power of the Court of Appeals to review the Tax Court on that issue. This court is not asked to review the evidence or inferences drawn from it.

Dearborn Motors Corporation, a subsidiary of Ford Motor Company, granted petitioner a franchise to sell Ford tractors, farm implements and equipment, industrial equipment and parts and accessories to dealers in the St. Louis area. The franchise was granted because of the success of two of petitioner's officers, Clay and Dutton, in operating a Ford tractor distributorship in New Orleans and because of the experience of another officer, Graham, with Ford in various managerial capacities. (R. 317-318). Graham devoted his whole time to the business. Clay and Dutton did not devote

all their time to the business, but devoted sufficient time to be conversant with its operation. Graham, Clay and Dutton participated in the making of all policy decisions.

The petitioner was organized June 27, 1947 with $25,000 capital. By June 30, 1952 it had earned surplus of $1,049,415.77 (R. 22-23).

Petitioner paid dividends for the years in question totaling $231,250 (R. 21). Tremendous income taxes were likewise paid.

For the fiscal years ended June 30, 1951 and June 30, 1952, the total salaries and bonuses paid the three officers were $203,562 and $189,783, respectively (R. 325). The Commissioner of Internal Revenue allowed total salaries totaling $62,735.62 and $75,521.90 for 1951 and 1952, respectively (R. 13-14). The Tax Court, without giving any reason and without discussion of the evidence, allowed total salaries of $102,000 for 1951 and $100,000 for 1952. The Eighth Circuit affirmed.

The pertinent operating figures were (R. 325):

Fiscal Year	Net Sales	Gross Profits	Net Income	Total Compensation to Officers	Net Income Before Compensation to Officers
1951	$8,272,478	$951,347	$413,841	$203,563	$617,404
1952	$7,955,079	$904,086	$354,575	$189,784	$544,360

The evidence with respect to the reasonableness of salaries, in addition to the figures showing the tremendous success and growth of petitioner, included:

Grenville D. Andrews, Vice President and General Sales Manager of Dearborn Motors Corporation in charge of all Ford tractor distributors during the years here involved, testified he was familiar with the opera-

tion of the petitioner and of all of the other 32 Ford tractor distributors. He received and analyzed the monthly financial reports of each distributor. Andrews felt that the petitioner was one of the most successful distributors and was in an area which had as highly competitive situation with regard to farm equipment as any area in the United States (R. 235). He said Graham, Dutton and Clay "were men of the highest ability and integrity" and that they had demonstrated over a period of years their ability to manage and direct the course of business of these companies through some very trying and some very hazardous times (R. 236). He testified with respect to the salaries here involved (R. 237):

> "Judging from the audited statements and the P and L statements that we received from month to month, I would say that they were in the middle range; there were salaries that were higher than theirs and there were salaries that were lower than theirs . . ."

Mr. Andrews testified that the salaries paid by petitioners were reasonable (R. 245).

Petitioner's proof did not stop with Andrews' testimony. Testimony was given by three other witnesses who operated a total of four Ford tractor distributorships identical with the one operated by petitioner, except for location. They were thoroughly familiar with petitioner's operation. They had intimate knowledge of and contact with petitioner's officers. Each witness testified as to the ability of Messrs. Graham, Clay and Dutton and each testified the salaries paid by petitioner were reasonable. Schippmann, who was president of a Ford tractor distributorship in Florida, and vice president of a Ford tractor distributorship in Atlanta,

testified the salaries were about in the middle range of salaries in the business. He said he would be glad to pay each $100,000 to accomplish the results they accomplished (R. 87-97, 173-182, 186-193).

Government Counsel did not ask any of these witnesses what their salaries were. The Government had access to the returns of all 33 Ford tractor distributors. It knew the salaries of the officers who ran these companies. It did not produce an officer of any of the companies as a witness to show that the salaries claimed in this case were not reasonable.

The Government did produce as a witness Arthur L. Berry, who had been president of a company which had distributed the Ferguson farm tractor, not Ford tractors. Its volume was not nearly as large as the volume of petitioner. The Berry company was forced to sell out to its supplier in 1957 (R. 299). Mr. Berry testified that he and his brother each received salaries of $18,000 per year and that the secretary-treasurer of his company was paid $5,400.

The Government did not ask Berry or any other witness if the salaries paid by petitioner were reasonable. Likewise, it did not ask its witness Berry or any other witness if the business of his company was comparable with the business of petitioner.

The Court of Appeals held: (1) "the Tax Court was not bound to believe the testimony of any witness, even though not directly contradicted" (App. 8a); and (2) the question before the Tax Court was a question of fact to be determined exclusively by the Tax Court.

REASONS FOR GRANTING THE WRIT

I.

The decision of the Court below that "the Tax Court was not bound to believe the testimony of any witnesses, even though not directly contradicted" (App. 8a) is in conflict with many decisions. Typical of these decisions is *Grace Bros.* v. *Commissioner* (CA 9, 1949), 173 F. 2d 170, 37 AFTR 1006, which states:

> "It is axiomatic that uncontradicted testimony must be followed. *Chesapeake and Ohio Railway Company* v. *Martin*, 1931, 283 U.S. 209, 216, 217, 51 S. Ct. 453, 75 L. Ed. 983; *San Francisco Association for Blind* v. *Industrial Aid for the Blind*, 8 Cir., 1946, 152 F. 2d 532, 536; *Foran* v. *Commissioner*, 5 Cir., 1948, 165 F. 2d 705. The only exception to the rule occurs when we are dealing with testimony by witnesses who stand impeached and whose testimony is contradicted by the testimony of others or by physical or other facts actually proved or with testimony which is inherently improbable."

The Fifth Circuit in *Foran* v. *Commissioner* (1948), 165 F. 2d 705, 36 AFTR 698, states:

> "We think the Court's refusal to follow the sworn testimony is contrary to law, and requires the setting aside of its fact finding as it would that of a jury."

To the same effect is *Ross* v. *Commissioner* (CA 5, 1955) 227 F. 2d 265, 48 AFTR 389.

As far back as *Baker* v. *Humphrey*, 101 U.S. 494, this Court stated:

> "These witnesses are unimpeached and are to be presumed unimpeachable. Their testimony is conclusive * * *."

Any deviation from this basic rule will result in chaos in the proof of facts.

II.

The decision of the Court below is in conflict with the decision of the Seventh Circuit in *Schuh Trading Company* v. *Commissioner* (1938), 95 F. 2d 404, 20 AFTR 1114, in which the Seventh Circuit reviewed the evidence in a Tax Court case and said:

> "The first two [questions] raise the issue of whether the ultimate findings of the Board were supported by the evidence, or were contrary to all the evidence. This question we must determine for such ultimate findings are subject to judicial review, and upon such review, the Court must substitute its judgment for that of the Board. *Helvering* v. *Tex Penn Oil Co.*, 300 U.S. 481. If the evidence before the Board as a trier of the facts ought to be convincing, it may not say that it is not, because it may not arbitrarily discredit the testimony of witnesses so far as they testify to facts; the facts must be fairly and judicially weighed and determination reached thereon."

III.

The decision of the Court below is in conflict with several salary decisions of the Court of Appeals for the Sixth Circuit. Typical is *Loesch & Green Construction Co.* v. *Commissioner* (1954) 211 F. 2d 210, 45 AFTR 458, in which the Court reviewed the evidence before the Tax Court and held:

> "Officers of similar and competing businesses who were acquainted with petitioner's business and its officers and their work, testified on the hearing that the salaries paid were 'very much' on the reasonable side, and were in line with the amounts

> paid for the same and similar services in other construction companies. Their testimony was unimpeached and should have been accepted by the Tax Court in a matter in which it had no knowledge or experience upon which it could exercise independent judgment; and such evidence cannot be arbitrarily disregarded."

In the *Loesch & Green* Case, there can be no doubt but that the Sixth Circuit did not consider that "the Tax Court was the exclusive judge of the credibility of the witnesses and the weight to be given their testimony." Under the rule stated by the Eighth Circuit in the case at bar, trial lawyers will be in a quandry as to how to prove facts. Certainly, the facts in a salary case cannot be better proved than they were in the case at bar. Certiorari should be granted to insure uniformity of decisions by the various Courts of Appeals.

Another Sixth Circuit decision in a salary case is *Mayson Manufacturing Co.* v. *Commissioner* (1949), 178 F. 2d 15, 38 AFTR 1028. The Sixth Circuit reviewed the evidence before the Tax Court and stated:

> "* * * * No witness testified that the compensation fixed by the Tax Court for each of the three officers was in fact reasonable compensation for the services rendered. We do not know from the record how those figures were arrived at. On the contrary, petitioner's testimony was that the compensation actually paid was reasonable compensation in each instance. No opportunity was afforded petitioner to cross-examine any witness who might have testified for the respondent to the contrary or to test the correctness or fairness of the figures selected by the respondent and the Tax Court. As was pointed out in *T. P. Taylor & Co.* v. *Glenn*, D. C., WD Ky., 62 F. Supp. 495, 499, 'If the com-

> pensation received * * * was unreasonable for the services rendered, certainly the government could have produced some experienced witness * * * who would have said so. The lack of such evidence operates very strongly against the defendant's contention.' * * * We recognize that in the present case petitioner's evidence on the issue was not from impartial witnesses. But, nevertheless, it was uncontradicted and was not referred to in the opinion of the Tax Court as being unworthy of belief. Under such circumstances, the failure of the Commissioner to introduce testimony supporting the deductions made by him lends considerable support to our view, gathered from other undisputed facts in the case, that the findings of the Tax Court on the issues involved are clearly erroneous and should be set aside."

See also *Capitol-Barge Dry Cleaning Co.* v. *Commissioner* (CA 6, 1942) 131 F. 2d 712, 30 AFTR 473 which held that "Where the testimony before the Board ought to have been convincing, it may not arbitrarily be disregarded."

IV.

The decision of the Court below is in conflict with the decision of the Court of Appeals for the First Circuit in *Heywood Boot & Shoe Co.* v. *Commissioner* (1935), 76 F. 2d 586, 15 AFTR 1192, in which the evidence before the Board of Tax Appeals was reviewed. In the *Heywood* case, the taxpayer's capital stock and surplus at the end of 1901 was about $133,000. By the end of October, 1926, they were more than $1,800,000. Cash dividends had been paid to stockholders averaging nearly 30% per year. For the fiscal year, 1926, the three officers were paid salaries totaling $160,000. The Board of Tax Appeals sustained the Commissioner in disallowing a portion of these salaries. The First Circuit reversed saying:

> "The Board in affirming the Commissioner's action made no finding that the additional compensation was out of line with what other similar concerns were paying under like circumstances"
>
> "The standard by which it determined the question of reasonableness is not stated and we do not understand what standard was used."

The identical situation exists in the case at bar

* * * * *

> "In the direct speech of the street, management such as the Heywood Company received is cheap at any price. As a business matter, the Heywood Company was justified in paying whatever compensation, within reasonable limits, was required to retain such management."

In the case at bar, the results were even more fantastic than in the Heywood case. The corporation started in 1947 with a capital of $25,000. At the end of its fifth fiscal year, it had earned surplus of $1,049,415.77. It had paid dividends on the stock totaling $231,250. On these facts, the Eighth Circuit said these exceptional men were not worth salaries totaling $203,562 in 1951 and $189,783 in 1952. After payment of these salaries, the petitioner had taxable income of $413,841 and $354,575 for 1951 and 1952, respectively.

V.

The decision of the Court below is in conflict with the decision of the Court of Appeals for the Fifth Circuit in *Express Publishing Co.* v. *Commissioner* (CA 5, 1944) 143 F. 2d 386, 32 AFTR 972, where the evidence was reviewed in a salary case and the Tax Court reversed.

In *R. P. Farnsworth & Co., Inc.* v. *Commissioner* (1953), 203 F. 2d 490, 43 AFTR 702, the Fifth Circuit reviewed the evidence and reversed the Tax Court in a salary case.

VI.

The decision of the Court below is in conflict with established law in that it has not applied the "clearly erroneous" rule, but in effect has applied the rule of the Dobson case 320 U.S., 489, which has been specifically overruled by legislation. (Public Law 773-80th Congress, 2nd Session) Senate Report No. 1559, 80th Congress, 2nd Session (1948) states:

> "The effect of this language was to repeal the rule laid down in *Dobson* v. *Commissioner of Internal Revenue* to the effect that decisions of the Tax Court on questions of fact, including questions of accounting and ultimate conclusions of fact, are not reviewable if supported by any evidence in the record. The effect of [the new provisions] was to make decisions of the Tax Court on questions of fact reviewable if clearly erroneous as is now the case with similar decisions of the district courts."

The decisions hereinbefore cited herein show that other Courts of Appeals are following the new statutory rule but that the Eighth Circuit is not. This Court in *United States* v. *United States Gypsum Co.*, 333 U.S. 364 stated (p. 395):

> "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing Court on the entire evidence is left with the definite and firm conviction that a mistake has been committed."

VII.

The questions presented by this case are important and should be resolved. If the Eighth Circuit is correct in holding that the Tax Court is not bound to believe the testimony of any witness, even though not directly contradicted, this Court should so state. Likewise, if the Eighth Circuit is correct in holding that the Tax Court is the exclusive judge of the credibility of the witnesses and the weight to be given their testimony, this Court should so state. We contend that the Eighth Circuit is out of step with other circuits on both points.

Respectfully submitted,

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August 22, 1960

APPENDIX

Opinion

UNITED STATE COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 16,336

MIDLAND FORD TRACTOR COMPANY, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Petition to Review Decision of the Tax Court of the United States.

[April 29, 1960]

Before GARDNER, WOODROUGH, and BLACKMUN, Circuit Judges.

GARDNER, Circuit Judge.

Petitioner seeks review of a decision of the Tax Court redetermining deficiencies in its income taxes for the fiscal years 1951 and 1952. The court disallowed a part of the amount claimed by petitioner for rents paid during the period in controversy on the ground that it was not required to be made as a condition to the continued use or possession of the leased property, and the court disallowed a part of the amount claimed as compensation paid to its officers on the ground that the payments were excessive and hence the excess disallowed was not an ordinary and necessary expense of carrying on petitioner's trade or

business. Section 23 (a) (1) (A), Internal Revenue Code of 1939.

Petitioner was incorporated in June, 1947, with a capital stock of 250 shares issued in equal shares of 83⅓ each to John J. Graham, Louis H. Clay, Sr., and Tom W. Dutton. In August, 1948, Louis H. Clay, Sr., transferred 33 shares to his son, Louis H. Clay, Jr. Petitioner's business consisted of distributing Ford tractors, farm implements and equipment, industrial equipment, and parts and accessories to dealers in 46 counties in eastern Missouri and 61 counties in southern Illinois, pursuant to a written contract with Dearborn Motors Corporation. From the date of its incorporation through approximately September, 1949, petitioner temporarily operated its business at 1210 Vandeventer Avenue in St. Louis. This property was leased for approximately $1,000.00 per month. On November 29, 1948, petitioner acquired 6.148 acres of unimproved land on Lindbergh Boulevard in Robertson, Missouri, for $11,269.85. This area was developing into the leading industrial district of St. Louis County.

Delta Realty Company was incorporated on April 14, 1949 with a paid-up capital of $1,000.00. The stockholders and officers of that company at the time of incorporation and during the controversial years and the shares held by each were: Tom W. Dutton, president, 333⅓ shares; Flossie Graham (wife of John J. Graham), secretary-treasurer, 333⅓ shares; Louis H. Clay, Sr., vice-president, 166⅔ shares; Louis H. Clay, Jr., 166⅔ shares. Petitioner sold the property it had acquired in Robertson, Missouri, to the Delta Realty Company for $11,269.85, the exact amount of the purchase price paid by it. Within two weeks after Delta was incorporated it leased to petitioner the property which it had purchased from it by a written lease containing the following provisions:

> "1. * * * to Have and to Hold the Same, * * * for * * * (a) term * * * commencing on * * * September (1), 1949, and ending on * * * August (31), 1954.

"2. Lessee shall pay * * * a fixed minimum yearly rental of * * * $18,000.00, payable in equal installments, in advance, of * * * $1,500.00 * * *.

"3. Lessee shall also pay to Lessor an additional rental for said premises for each lease year in which one per cent * * * of the net sales * * * of Lessee exceeds the fixed minimum yearly rental, such additional rental to be equal to the amount by which one per cent * * * of the net sales of Lessee exceeds such fixed minimum yearly rental. Such additional rent shall be payable as follows: On or before the 15th day of the following month, Lessee shall pay to Lessor the amount by which one-half * * * of one per cent * * * of the net sales during such preceding month exceeds * * * $1,500.00. * * *

" * * * Lessee shall, on or before the fifteenth day of each month during the whole term of this lease and of the month following the expiration thereof, render to Lessor an accurate statement showing the net sales of Lessee for the preceding month * * *.

"4. Lessee * * * agrees * * * (to) pay * * * taxes, duties, assessments, * * *

"5. * * * carry insurance * * * (u)pon the improvements * * * now or hereafter erected on the leased premises * * *.

* * * * * * * *

"7. (Maintenance expenses.)

"8. Lessee, upon the signing of this lease, is to deposit with Lessor * * * $25,000.00 as security * * *.

* * * * * * * *

"12. Lessee shall have the option to * * * (renew this lease for an additional 5 years.)"

At the time of the execution of this lease the property was unimproved, but Delta thereafter erected a building on the leased premises at an approximate cost of $120,000.00. It therefore had a total investment in the property of approximately $131,000.00. Petitioner occupied the leased property during fiscal years 1951 and 1952. Petitioner paid in accordance with the terms of its lease for

the taxable years here under consideration the aggregate sum of $162,280.51 as rent, plus taxes of $3,014.32, insurance of $1,680.42, and maintenance of $842.35 making a total of $167,817.60, and deducted that amount from its gross income in its tax returns for the fiscal years 1951 and 1952. It appears from the record that actual rentals paid under the lease for the fiscal years 1950 to 1952, inclusive, aggregated more than $225,000. Thus, Delta, the lessor, recovered almost double its original investment of about $131,000.00 in less than three years. Petitioner contends that the Tax Court erred in reducing the amount claimed by it as rental.

As has been observed, the stockholders of petitioner were also stockholders of the Delta Realty Company. Three of the four stockholders of petitioner, owning more than 50% of its stock, also owned 666⅔ out of the 1,000 shares issued by Delta and consequently controlled Delta. The rest of the stock of petitioner was owned by John J. Graham, while the remainder of the stock of Delta was owned by Graham's wife.

The statute involved, so far as here pertinent, reads as follows:

> "Sec. 23. DEDUCTIONS FROM GROSS INCOME.
>
> "In computing net income there shall be allowed as deductions:
>
> "(a) Expenses.—
>
> "(1) Trade or business expenses.—
>
> "(A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

In view of the fact that petitioner's stockholders owned more than a majority of the stock of the Delta Realty Company, petitioner, in contracting with it, in effect was contracting with itself under the name of Delta Realty Company. Under the facts of this case the parties could not be said to be dealing at arm's length and no presumption of the deductibility of the entire amount paid as rentals under the lease attaches. In *Brown Printing Co.* v. *Commissioner*, 5 Cir., 255 F.2d 436, it is said:

> "It is entirely appropriate, therefore, for the Commissioner to inquire into payments in the nature of rent and disallow such part as may be excessive in amount, and if such determination of disallowance is soundly based, his action carries with it a presumption of correctness. Furthermore, while the actual contract made between parties dealing fully at arm's length is usually persuasive of its reasonableness, no such inference can arise from the execution of a contract between persons having an interest on both sides of a transaction."

It was the function of the Tax Court to determine as a fact what was a reasonable rental to be paid by petitioner. This the Tax Court has done and its finding is presumptively correct and should not be set aside unless clearly erroneous. It is argued that the Tax Court failed to consider certain facts bearing on the question of the reasonableness of the rent paid. The Tax Court received and considered all the evidence offered by petitioner. We have carefully examined the decision of the Tax Court which includes its findings. In the course of its decision it is said:

> "As to the rental issue, under all the circumstances, including the type and term of the lease, we have found that a rental figure for the property reasonably required for its continued use by petitioner during the years in controversy was not in excess of $37,500 a year. In arriving at this figure we have taken into consideration what we have determined to be a reasonable rental if the amount were definitely fixed in ad-

vance for a customarily long term, and also what percentage of net sales would be adequate to induce an unrelated landlord to enter into a comparable agreement at the time of the original lease. See *Brown Printing Co.* v. *Commissioner* (C. A. 5), 255 F.2d 436, reversing T.C. Memo. 1957-37. The amount properly deductible as rent incorporated in our findings is consistent with our conclusions in these respects. A minimum amount of $18,000 was payable in any event, even in a bad year. The difference represents the most we think petitioner's landlord could reasonably expect in a good year for his risk on account of the percentage clause and the possibility of nonrenewal."

There was expert evidence produced by the Commissioner fully sustaining the court's finding and it was the province of the trial court to resolve all conflicts in the evidence and we may assume the conflicts were resolved in favor of the Commissioner. A review of the testimony would unduly extend this opinion and serve no useful purpose. Suffice it to say that there was conflict in the evidence and the evidence on behalf of the Commissioner, if believed by the court, was substantial and abundantly sustained the court's findings.

Petitioner has cited and relies upon *West Virginia Tractor & Equipment Co.*, 54,016 P.H. Memo. T.C., and *Southern Ford Tractor Corporation* v. *Commissioner*, 29 T.C. 833. The cases are readily distinguishable from the instant case. In *Southern Ford Tractor Corporation* v. *Commissioner*, supra, the taxpayer sustained the burden of proof of the reasonableness of the rental. In that case there was testimony that the rental agreed upon was determined after a very thorough investigation on the part of the taxpayer as to rentals paid under similar circumstances and past sales of the taxpayer were studied to determine the percentage of sales to be used as rentals. In *West Virginia Tractor & Equipment Co.*, supra, the court held:

"* * * that the lease agreement of September 11, 1940, was entered into in an arms-length transaction,

and that the payments made by the petitioner in 1947, 1948, and 1949, pursuant to the terms of the lease, were in fact required to be made as a condition to the continued use and possession of the property."

The redetermination of the amount deductible from petitioner's gross income for rent paid must be sustained.

Petitioner contends that the Tax Court erred in disregarding the uncontradicted and unimpeached testimony of petitioner's witnesses as to the value of personal services rendered to petitioner by its officers and in holding that part of the compensation paid was excessive and unreasonable. On November 27, 1950, the directors of petitioner, who were also its stockholders and officers, fixed their salaries as officers as follows: The monthly salary of Graham at $2,500, and the monthly salaries of Clay and Dutton at $1,500 each, and in addition to these salaries, Graham was to receive 12½% of the net profits in excess of $100,000.00 and Clay and Dutton were each to receive 10% of the net profits in excess of $100,000.00. Pursuant to this authorization there was paid to the three officers named the aggregate sum of $203,563 as compensation for the fiscal year 1951 and the aggregate sum of $189,784 as compensation for the fiscal year 1952, and these amounts were, in petitioner's tax returns for the years here involved, deducted from the gross income of petitioner. Graham, as president and general manager, devoted his entire time to the business of petitioner but Clay and Dutton devoted only part time to that service and were employed by certain other companies and each received annually from these other employments over $50,000.00. Graham, Clay, and Dutton were witnesses for petitioner and testified as to the character and extent of their services and, as experts, testified that the compensation received by each was, in their opinion, reasonable. There was testimony of persons related to them in a business way and friendly to them, tending to corroborate the testimony of petitioner's officers. On behalf of the Com-

missioner there was evidence that the Berry Tractor and Equipment Company, for the fiscal years ended September 30, 1951, and September 30, 1952, paid officers of the company, whose services were comparable to those of petitioner's officers, as follows: President, $18,000.00, Vice-President, $18,000.00, Secretary-Treasurer, $5,400.00. It appears from the record that while volume of petitioner's net sales increased about 15% from the fiscal year 1950 to the fiscal year 1951, the total compensation of officers was increased from $55,500.00 to $203,563.00 in the same period. Dividends, on the other hand, decreased from $125,000.00 in 1950 to $50,000.00 in 1951, and manifestly the distribution of the earnings of the company had the effect of very substantially reducing the excess profit taxes collectible against petitioner. In view of all of these proven or admitted facts and circumstances, it cannot reasonably be contended that the evidence produced by the petitioner was "uncontradicted and unimpeached."

The question before the Tax Court was a question of fact to be determined by all the facts and circumstances in evidence. The Tax Court was not bound to believe the testimony of any witness even though not directly contradicted. It was the exclusive judge of the credibility of the witnesses and the weight to be given to their testimony. *Builders Steel Co.* v. *Commissioner*, 8 Cir., 197 F.2d 263; *Skelly Oil Co.* v. *Holloway*, 8 Cir., 171 F.2d 670; *Aetna Life Ins. Co.* v. *Kepler*, 8 Cir., 116 F.2d 1; *Nee* v. *Linwood Securities Co.*, 8 Cir., 174 F.2d 434; *Anchor Co.* v. *Commissioner*, 4 Cir., 42 F.2d 99. We conclude that there was substantial evidence sustaining the finding of the Tax Court on this question of reasonableness of compensation paid petitioner's officers, and hence its decision cannot be said to be clearly erroneous. Its decision is therefore affirmed.

T. C. Memo. 1958-213

TAX COURT OF THE UNITED STATES

MIDLAND FORD TRACTOR COMPANY, a corporation, Petitioner, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket No. 59299. Filed December 17, 1958.

Robert Ash, Esq., Carl F. Bauersfeld, Esq., and *Don O. Russell, Esq.*, for the petitioner.

Richard G. Worden, Esq., for the respondent.

Memorandum Findings of Fact and Opinion

OPPER, *Judge:* Respondent determined deficiencies in petitioner's income tax for the fiscal years ended June 30, 1951 and 1952, in the amounts of $139,128.94 and $114,225.43, respectively.

The questions presented are: (1) Whether rental payments were required as a condition to the continued use or possession of the leased property; (2) whether salaries paid to petitioner's officers were reasonable compensation for services rendered.

FINDINGS OF FACT

Certain facts were stipulated and are incorporated herein by this reference.

Petitioner is a Missouri corporation with its principal place of business in Hazelwood, St. Louis County, Missouri. Petitioner filed income tax returns for fiscal years 1951 and 1952 with the then collector of internal revenue for the first district of Missouri. It keeps its books and records on an accrual basis and reports its income for fiscal years ending June 30.

Petitioner was incorporated on June 27, 1947 and issued 250 shares of stock equally to John J. Graham, Louis Clay, Sr., and Tom W. Dutton, hereafter referred to as Graham, Clay and Dutton, respectively. On or about August 15, 1948, Clay transferred to his son, Louis Clay, Jr., 33 shares. No further transfers were made prior to June 30, 1952.

The officers and directors of petitioner since its organization and during the controversial period were Graham, president, Clay, vice-president and Dutton, secretary-treasurer.

Petitioner's business consisted of distributing Ford tractors, farm implements and equipment, industrial equipment and parts and accessories to dealers in 46 counties in eastern Missouri and 61 counties in southern Illinois, hereafter referred to as the St. Louis area, pursuant to a written contract with Dearborn Motors Corporation, hereafter referred to as Dearborn. This contract was terminable by either party on 30 days' notice. Dearborn cautioned petitioner that it might distribute its products directly and petitioner would lose its distributorship.

Prior to 1947 Ford Motor Company, hereafter referred to as Ford, manufactured farm tractors and related equipment for Harry Ferguson, Inc., hereafter referred to as Ferguson. Ferguson marketed the "Ford-Ferguson" tractor and "Ferguson Farm" implements through 32 independant distributors. In October 1943, Clay and Dutton formed Clay-Dutton, Inc., a Lincoln-Mercury dealership in New Orleans, Louisiana. In 1944, Clay-Dutton, Inc., procured the retail franchise for the sale of Ford-Ferguson tractors and the Ferguson system of implements. Following a series of disagreements, Ford and Ferguson dissolved their relationship in June 1947 and Ford manufactured these products for Dearborn, a corporation controlled by the officers and directors of Ford.

Southern Ford Tractor Corporation, hereafter referred to as Southern Ford, was a former Ferguson distributor

in New Orleans, Louisiana, owned by Clay and Dutton. In January 1947, Clay and Dutton were notified of the Ford-Ferguson severance and the formation of Dearborn. Southern Ford became a Dearborn distributor in 1947. Between February 1947 and June 1947, Clay and Dutton decided to procure another tractor distributorship and conferred in Detroit with officials of Dearborn. Upon advice that the St. Louis distributorship was available, Clay and Dutton investigated farm conditions thereabouts. They determined that the farm equipment business in that area was highly competitive and would require not only their constant attention and supervision but also a capable and experienced associate to handle the daily details of the operation of the business. They solicited Graham who had many years of experience with Ford in various managerial capacities. Dearborn required their distributors to produce $100,000 minimum operating capital and to establish suitable physical facilities. Clay, Dutton and Graham formed petitioner which became Dearborn's distributor in the St. Louis area. They borrowed the necessary capital from Universal C.I.T. Corporation. A personal loan of $25,000 was made to Clay, Dutton and Graham and used to purchase the original stock in petitioner. After petitioner was organized, the Universal C.I.T. Corporation loaned petitioner an additional $75,000.

Dearborn granted petitioner the distributorship because of the past performance of Southern Ford, the financial ability of Clay and Dutton to carry on a distributorship and the employment of Graham.

Employees of Southern Ford trained petitioner's new personnel. Petitioner had contracts with 110 to 120 dealers in the St. Louis area from April 30, 1948 through June 30, 1952 and was one of Dearborn's most successful distributorships.

Ferguson brought suit against Ford, Dearborn and all its officers in the United States District Court for the

Southern District of New York for $250,000,000. Clay was subpoenaed by Ferguson individually and as an officer-director of petitioner, Clay-Dutton, Inc., and Southern Ford. His deposition was taken in New Orleans, Louisiana, from October 13 through October 17, 1950 and covered 315 pages. Petitioner was not a defendant in this suit.

On September 21, 1948, Berry Tractor and Equipment Co., Inc., hereafter referred to as Berry, as plaintiff, sued Ford, Dearborn and other defendants including petitioner and petitioner's officers in the United States District Court for the Eastern District of Missouri for $10,500,000 under the Clayton Act. Berry was a Ferguson disfributor in the St. Louis area and 1 of the 6 distributors that remained with Ferguson in 1947. This lawsuit was dismissed in April 1952 and neither petitioner nor its officers paid damages. During the controversial years, petitioner's officers conferred with other defendants in this suit. Clay and Dutton refrained from entering St. Louis to avoid service of process. They performed duties for petitioner in East St. Louis and at regional meetings.

Petitioner's earned surplus account from fiscal years 1948 through 1952 was $214,065.64, $595,603.53, $744,239.33, $920,799.74 and $1,049,415.77, respectively. No reserve account for possible litigation expenses appeared on petitioner's balance sheets from 1949 through 1952.

Delta Realty Company, hereafter referred to as Delta, was incorporated in Missouri on April 14, 1949. The stockholders and officers of Delta at the time of incorporation and during the controversial years, and the shares held by each were as follows:

Name and title	No. of shares
Tom W. Dutton, president	333⅓
Flossie Graham (wife of John J. Graham), secretary-treasurer	333⅓
Louis H. Clay, Sr., vice-president	166⅔
Louis H. Clay, Jr.	166⅔

Delta received $1,000 in payment for the 1,000 shares of stock issued at or about the time of its incorporation. This was the entire amount of its paid-in capital.

From the date of its incorporation through approximately September 1949, petitioner temporarily operated its business at Vanderventer Avenue in St. Louis. This property was leased for approximately $1,000 per month. On November 29, 1948, petitioner acquired 6.148 acres of unimproved land on Lindbergh Boulevard in Robertson, Missouri, for $11,269.85. This area was developing into the leading industrial district of St. Louis County. Petitioner sold this land to Delta on April 28, 1949 for $11,269.85, which Delta paid December 1, 1949.

The net sales of petitioner for fiscal year 1949, as of March 31 and April 30, were $5,882,274.93 and $6,749,333.74, respectively.

On or about April 28, 1949, Delta and petitioner entered into a written lease agreement covering the land, and a building which was to be erected, both hereafter referred to as the Lindbergh Boulevard property. The lease provided, among other things:

* * * * * * * * *

1. * * * TO HAVE AND TO HOLD THE SAME, * * * for * * * [a] term * * * commencing on * * * September [1,] 1949, and ending on * * * August [31,] 1954.

2. Lessee shall pay * * * a fixed minimum yearly rental of * * * $18,000.00, payable in equal monthly installments, in advance, of * * * $1,500.00 * * *.

3. Lessee shall also pay to Lessor an additional rental for said premises for each lease year in which one per cent * * * of the net sales * * * of Lessee exceeds the fixed minimum yearly rental, such additional rental to be equal to the amount by which one per cent * * * of the net sales of Lessee exceeds such fixed minimum yearly rental. Such additional rent shall be payable as follows: On or before the 15th day of the following month, Lessee shall pay to

Lessor the amount by which one-half * * * of one per cent * * * of the net sales during such preceding month exceeds * * * $1,500.00. * * *

* * * * * * * * * *

* * * Lessee shall, on or before the fifteenth day of each month during the whole term of this lease and of the month following the expiration thereof, render to Lessor an accurate statement showing the net sales of Lessee for the preceding month * * *.

4. Lessee * * * agrees * * * [to] pay * * * taxes, duties, assessments, * * *

5. * * * carry insurance * * * [u]pon the improvements * * * now or hereafter erected on the leased premises * * *.

* * * * * * * * * *

7. [Maintenance expenses.]

8. Lessee, upon the signing of this lease, is to deposit with Lessor * * * $25,000.00 as security * * *.

* * * * * * * * * *

12. Lessee shall have the option to * * * [renew this lease for an additional 5 years.]

Delta erected a building on the leased premises at an approximate cost of $120,000. Delta executed and delivered demand notes to and borrowed from the Tower Grove Bank, St. Louis, Missouri, the following amounts:

Date	Amount
6/2/49	$12,000.00
8/1/49	30,000.00
8/31/49	42,000.00
9/9/49	20,000.00
10/14/49	10,000.00
11/10/49	25,000.00
12/5/49	97,000.00

The loan of August 31, 1949 was a renewal of the two prior loans. The loan of December 5, 1949 was a renewal of unsatisfied prior loans. On January 12, 1950, the loan account was closed by transfer to the bank's real estate

department of the $97,000, an additional $48,000 was loaned to Delta and a deed of trust covering the Lindbergh Boulevard property was executed by Delta to secure repayment of the $145,000. The monies borrowed from Tower Grove Bank were used to finance the construction of the building on the Lindbergh Boulevard property.

Delfa made regular payments pursuant to the mortgage and on December 3, 1952 made an advance payment of $30,000. On or about June 1, 1954, the unpaid balance of $25,000 was renewed until June 1, 1955. Eleven monthly payments of $1,250 were made and the balance of $11,250 was paid in full on May 29, 1955. This was a building with limited uses. It could be used for warehousing and industrial operations. The building, completed in the fall of 1949, contains a total of approximately 31,000 square feet and is constructed of brick, concrete block, steel sash and metal ceilings. The office space is about 5,000 square feet and is finished with plastered walls and tile floors. A smaller building containing about 4,000 square feet was erected on the property during the year 1952. No depreciation was claimed on this second building in the income tax return filed by Delta for the taxable year ended March 31, 1952.

Petitioner occupied the Lindbergh Boulevard property during 1951, 1952 and for 9 months during fiscal year 1950. Expenses incurred by petitioner pursuant to the lease from fiscal year 1950 through fiscal year 1952 were:

Year	Rent	Taxes	Insurance	Maintenance
1950	$63,707.17	$ 3.85	$419.95	$3,538.11
1951	82,729.70	1,451.92	839.64	——
1952	79,550.81	1,562.40	840.78	842.35

On February 16, 1955, Melvin Dubinsky, a witness on behalf of petitioner, estimated the fair rental value of the Lindbergh Boulevard property as of April 28, 1949 to be $26,250.

The lease agreement between Delta and petitioner entered into on April 28, 1949 was not at arm's length. The rental was unreasonably high. In 1951 and 1952 amounts paid as rent by petitioner to Delta exceeding $37,500 per year were not required to be made as a condition to the continued use and possession of the property.

The farm equipment business fluctuates because it follows farm income. Petitioner was required to carry inventories of farm tractors and approximately 115 different types of implements, corn pickers, combines, side delivery rakes, forage harvesters, hay balers and cotton pickers. Petitioner used the original $100,000 of capital for payment of sight draft bills of lading on tractor parts, implement parts and accessory inventories plus an amount for operating expenses. Petitioner arranged with Universal C.I.T. Corporation to finance by the floor plan method its inventory of tractors and farm implements which required the personal endorsement of Clay, Dutton and Graham.

In 1951 and 1952, Clay and Dutton devoted part of their time, and Graham devoted his entire time, to petitioner. Clay, in addition to advisory duties and assistance to Graham, was responsible for policies and contacts between Dearborn and petitioner and for the procurement of outside implements, accessories and other items necessary to assist dealers on a more profitable basis. Dutton, in addition to advisory duties and assistance to Graham, was responsible for all financial matters. Graham was petitioner's general manager with full and complete charge of the operation of the business.

Petitioner's officers were engaged in the distribution, sale, promotion and demonstration of tractors and equipment. They trained distributor, dealer and sales personnel. They forecasted and determined what different implements and tractors would be needed in the business and required for plowing, planting, cultivating and harvesting. They ordered these from Dearborn and other farm equipment manufacturers. The officers determined the actual and potential use in the St. Louis area of newly

introduced equipment. They ordered parts for servicing the tractors. The officers encountered problems in connection with a change in a brand name and defective equipment.

In addition to Graham, Clay and Dutton, petitioner employed 45 to 50 people, including a sales manager, parts manager, product education manager, advertising and promotion manager, business management manager and 6 to 8 district supervisors.

From 1947 through January 9, 1950, petitioner's directors voted the following monthly salaries for themselves as officers:

	6/24/47	12/6/47	1/12/48	1/10/49	1/9/50
Clay	$ —	$ 500	$ 500	$ 500	$ 500
Dutton	—	500	500	500	500
Graham	1,000	1,500	1,500	1,500	1,500

Petitioner's accountant wrote a letter to Graham on November 21, 1950. It contained, in part, the following:

> I have studied over carefully the figures of your company for the past three fiscal years and have come to the conclusion regarding compensation to be paid to the officers of the company that should be considered reasonable by the Internal Revenue Department.
>
> In my opinion, a salary of $48,000.00 a year could be paid to you as a full time official of the company, while remuneration of $18,000.00 per year, each, for Mr. Clay and Mr. Dutton for their part time services in behalf of the company could be justified.
>
> In arriving at my conclusions I have taken into consideration the volume of business done by the company, the net profits that have resulted from its operation, the dividends that have been paid, as well as, the ability of the officers and the services which they have rendered to the corporation. These salaries would be less than one and one-quarter per cent of the total volume of business done by the company and less than twenty per cent of the net profits of the company before considering salaries of officers as an expense.

These factors are all in your favor and should justify the remuneration stated above.

The directors met on November 27, 1950 and the minutes in part provided:

The chairman stated that the purpose of the meeting was to definitely fix the compensation of the officers of the company which had been discussed previously from time to time.

The chairman stated that, in his opinion, the finances and stability of the company was [sic] such, now, that it was not necessary for the officers to further postpone taking compensation commensurate with the services they were rendering to the company. He further stated that in addition to a monthly salary the officers of the company should share in the profits of the company in excess of a given amount, inasmuch as the earnings of the company were largely dependent upon the efforts put forth by the officers.

A lengthy discussion followed, after which a motion was made and seconded, fixing the monthly salaries of the officers effective December 1, 1950, as follows:

John J. Graham, President —$2,500.00 per month

L. H. Clay, Vice President—$1,500.00 per month

T. W. Dutton, Secretary and Treasurer—$1,500.00 per month

In addition to the above salary each officer is to receive, at the close of the corporation's fiscal year, June 30th, additional compensation if earnings of the company are in excess of $100,000.00, after considering above salaries as an expense and before considering federal income and excess profits taxes and state income taxes as a deduction; said additional compensation to be computed as follows:

John J. Graham, President, 12½% of the net profits, in excess of $100,000.00, before considering federal and state income and excess profits taxes as a deduction.

L. H. Clay, Vice President, 10% of the net profits, in excess of $100,000.00, before considering federal and state income and excess profits taxes as a deduction.

T. W. Dutton, Secretary and Treasurer, 10% of the net profits, in excess of $100,000.00, before considering federal and state income and excess profits taxes as a deduction.

Petitioner's net sales, gross profit, net income, total compensation paid to its officers and net income before officers' compensation for the fiscal years 1948 through 1952, inclusive, were (in even dollars) as follows:

Fiscal year	Net sales	Gross profits	Net income	Total compensation of officers	Net income before officers' compensation
1948	$4,338,106	$510,049	$346,187	$ 38,267	$384,455
1949	7,854,864	887,953	625,453	55,500	680,953
1950	7,203,868	796,265	441,092	55,500	496,592
1951	8,272,478	951,347	413,841	203,563	617,404
1952	7,955,079	904,086	354,575	189,784	544,360

Petitioner claimed deductions for officers' compensation on its income tax returns for the fiscal years 1948 through 1952, inclusive, (in even dollars) as follows:

	1948	1949	1950	1951	1952
Graham—					
Salary	$17,000	$18,000	$18,000	$25,000	$30,000
Bonus	5,089	8,500	8,500	58,678	47,609
Totals	$22,089	$26,500	$26,500	$83,678	$77,609
Clay—					
Salary	$ 3,000	$ 6,000	$ 6,000	$13,000	$18,000
Bonus	5,089	8,500	8,500	46,942	38,087
Totals	$ 8,089	$14,500	$14,500	$59,942	$56,087
Dutton—					
Salary	$ 3,000	$ 6,000	$ 6,000	$13,000	$18,000
Bonus	5,089	8,500	8,500	46,942	38,087
Totals	$ 8,089	$14,500	$14,500	$59,942	$56,087
Grand Totals	$38,267	$55,500	$55,500	$203,562	$189,783

In 1951 and 1952, Clay and Dutton received compensation for services from enterprises other than petitioner (in even dollars) as follows:

	1951		1952	
	Clay	Dutton	Clay	Dutton
Clay-Dutton, Inc.	$23,000	$25,000	$23,000	$25,000
Southern Ford	25,000	23,000	25,000	23,000
Riverside Motors, Inc.	1,200	1,200	1,200	1,200
Delta	3,000	3,000	3,000	3,000
Opdenweyer Aleus Co.	—	2,950	—	3,000

From 1949 through 1952, respectively, petitioner paid the following dividends: $6,250, $125,000, $50,000 and $50,000. Petitioner paid no dividends in 1948.

No part of the compensation paid in 1951 and 1952 by petitioner to its officers for services rendered represented payment for services rendered in prior years.

Reasonable compensation for services rendered to petitioner by its officers was $102,000 and $100,000 for the respective fiscal years 1951 and 1952.

Opinion

The parties are in virtual agreement on most aspects of the present controversy, except for the ultimate issues. These are solely factual and are disposed of in our findings. See *Southern Ford Tractor Corporation*, 29 T.C. 833. But the considerations to be taken into account in arriving at these conclusions are scarcely in dispute at all.

Thus, in dealing with the contested deductions for rent and officers' compensation, it is apparently accepted by both sides that the arrangements involved were not made at arm's length because of the close relationship of the parties, on the one hand, but that, on the other, the question for our decision is what would have been agreed upon under similar circumstances between unrelated parties;

that the extent to which the expenditures in question are deductible is a question of fact to be determined in the light of all the circumstances as they existed at the time the amounts were fixed and without giving undue weight to any single aspect; that in the case of rent or compensation dependent upon earnings, a larger figure may be justified in the light of the possibility that other less successful years will compensate for those unusually prosperous; that the fair rental value of the property under a fixed rental agreement with a reasonably long term and a wholly responsible tenant would be somewhere in the neighborhood of $26,000 a year; and that the fact that an officer devotes only part of his time to his duties for his employer may be taken into account in fixing reasonable compensation.

As to the rental issue, under all the circumstances, including the type and term of the lease, we have found that a rental figure for the property reasonably required for its continued use by petitioner during the years in controversy was not in excess of $37,500 a year. In arriving at this figure we have taken into consideration what we have determined to be a reasonable rental if the amount were definitely fixed in advance for a customarily long term, and also what percentage of net sales would be adequate to induce an unrelated landlord to enter into a comparable agreement at the time of the original lease. See *Brown Printing Co. v. Commissioner*, (C.A. 5) 255 F. 2d 436, reversing T. C. Memo. 1957-37. The amount properly deductible as rent incorporated in our findings is consistent with our conclusions in these respects. A minimum amount of $18,000 was payable in any event, even in a bad year. The difference represents the most we think petitioner's landlord could reasonably expect in a good year for his risk on account of the percentage clause and the possibility of nonrenewal. . . .

One contention advanced by respondent should perhaps be briefly noted. In discussing the short term of the lease,

he says in his brief: "* * * in view of the close relationship between the lessor and the lessee, the term of the lease is unimportant." The inconsistency thus suggested is one with which we cannot agree. Respondent's position is that the lease was unreasonable because the relationship of the parties prevented them from dealing at arm's length, and the resulting arrangements must be scrutinized accordingly. If we are attempting to ascertain what terms would have been agreed upon by unrelated parties, we cannot at the same time assume that the term of the lease is unimportant for the very reason that the parties were related.

Again considering all the circumstances, we have concluded that reasonable compensation to petitioner's three officers for 1951 would not exceed $102,000, and for 1952, $100,000. Since we have taken into consideration the contingent character of a part of the compensation paid to the officers, it seems appropriate that the total reasonably necessary for 1952 should be somewhat less than that for 1951. And the fact that two of the three officers concerned spent only part of their time on petitioner's problems indicates that a total reasonable compensation payable to all the officers is a more logical approach than an effort to allocate this amount among the three officers. We have made our findings accordingly.

On the entire record we have concluded as appears in our findings that respondent's determination is disapproved to the extent indicated.

Decision will be entered under Rule 50